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No. 80-1935

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

A. SPENCER GILBERT III, Trustee in Bankruptcy for Char-Mac Enterprises, Inc., *et al.*,
Petitioner

v.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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May 18, 1981

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QUESTIONS PRESENTED FOR REVIEW

1. Whether a setoff is a "transfer" for purposes of Section 67d of the Bankruptcy Act.

2. Whether under Section 67d or Section 68 of the Bankruptcy Act a trustee in bankruptcy can avoid a bank setoff where deposits are received in bad faith, outside the ordinary course of business, and for the purpose of setoff.*

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* Petitioner is Trustee in Bankruptcy for Charles E. Duran, for his wife, Rachel R. Duran, and for his wholly owned corporation Char-Mac Enterprises, Inc. There are no parent corporations, partially owned subsidiaries, or affiliates of Char-Mac Enterprises, Inc.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED FOR REVIEW	i
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION OF THIS COURT	2
STATUTES INVOLVED	2
STATEMENT OF THE CASE	3
(1) Statement of Facts	4
(2) District Court Proceedings	5
(3) The Court of Appeals Decision	5
REASONS FOR GRANTING THE WRIT	6
I. The Fifth Circuit has Decided an Important Issue of Federal Bankruptcy Law Contrary to the Decisions of this Court	6
II. A Bank Setoff is a "Transfer by the Debtor"	8
CONCLUSION	10
APPENDICES	
Appendix A—Opinion of the United States Court of Appeals for the Fifth Circuit	1a
Appendix B—Opinion of the United States District Court for the Southern District of Mississippi	7a
Appendix C—Judgment of the Court of Appeals	15a
Appendix D—Order of the Court of Appeals denying petitioner's Petition for Rehearing and Petition for Rehearing *en banc*	16a

TABLE OF AUTHORITIES

CASES — Page

Bank of Commerce & Trusts v. Hatcher, 50 F.2d 719 (4th Cir. 1931) 7
Bank of Marin v. England, 385 U.S. 99 at 103 (1966) 9
Citizens' National Bank v. Lineberger, 45 F.2d 522 (4th Cir. 1930) 6
Dean v. Davis, 242 U.S. 438 (1917) 8
Elliotte v. American Savings & Trust Co., 18 F.2d 460 (6th Cir. 1927) 6-7
Essex Bank v. Hurley, (C.C.A. 1) 16 F.(2d) 427, 428 7
In the Matter of Multiponics, Inc., (Multiponics II), 622 F.2d 725 (5th Cir. 1980) 7
In the Matter of PRS Products, Inc., 574 F.2d 414 (8th Cir. 1978) 7
Katz v. The First National Bank of Glen Head, 568 F.2d 964 (2nd Cir. 1977) *cert. denied* 434 U.S. 1069 7
Mechanics & Metals National Bank v. Ernst, 231 U.S. 60 (1913) 6
Merrimack Bank v. Bailey, (C.C.A.1) 289 F. 468, *cert. denied*, 263 U.S. 704 7
New York County National Bank v. Massey, 192 U.S. 138 (1904) 6
Pirie v. Chicago Title & Trust Co., 182 U.S. 483, (1901) 9
Studley v. Bolyston National Bank of Boston, 229 U.S. 523 (1913) 6
Union Trust Co. v. Peck, (C.C.A.4) 16 F. (2d) 986, 987 7

STATUTES

Bankruptcy Act:

Section 1(30), 11 U.S.C. § 1(30) (1976) 2, 9
Section 60, 11 U.S.C. § 96 (1976) 5, 8, 9
Section 67d, 11 U.S.C. § 107d (1976) ..... *passim*
Section 68, 11 U.S.C. § 108 (1976) ..... *passim*

TABLE OF AUTHORITIES—Continued

	Page
Section 70d, 11 U.S.C. § 110(d) (1976)	9
Section 70e, 11 U.S.C. § 110(e) (1976)	5
Bankruptcy Code (1978):	
11 U.S.C. § 553 (1978)	6
MISCELLANEOUS	
1 COLLIER ON BANKRUPTCY, ¶ 1.30 (14th Ed.)	9
4 COLLIER ON BANKRUPTCY, ¶ 68.15 (14th Ed.)	7
H.R. Rept. No. 95-595, 95th Cong., 1st Sess. (1977)	6

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A. SPENCER GILBERT III, Trustee in Bankruptcy for Char-Mac Enterprises, Inc., *et al.*,
Petitioner

v.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

A. Spencer Gilbert III, Trustee in Bankruptcy, respectfully petitions the Court for a Writ of Certiorari to issue to the United States Court of Appeals for the Fifth Circuit to review that Court's Judgment and Opinion in *Gilbert v. First National Bank*, No. 79-1310, entered on December 29, 1980.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Fifth Circuit appears in Appendix A of this petition and is reported at 633 F.2d 686 and CCH Bankruptcy Reporter ¶ 67,744. The Opinion of the United States District Court for the Southern District of Mississippi dismissing the Complaint appears in Appendix B of this

petition and is reported at 463 F.Supp. 169. The Judgment of the Court of Appeals appears in Appendix C and the Order of the Court of Appeals denying petitioner's Petition for Rehearing and Petition for Rehearing *en banc* appears in Appendix D.

JURISDICTION OF THIS COURT

The Opinion and Judgment of the Court of Appeals for the Fifth Circuit was entered on December 29, 1980. The timely Petition for Rehearing and Petition for Rehearing *en banc* were denied on February 17, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1976).

STATUTES INVOLVED

Section 1(30) of the Bankruptcy Act, 11 U.S.C. § 1(30) (1976), reads in pertinent part:

> " 'Transfer' shall include the sale and every other different mode, direct or indirect, or disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor."

Section 67d of the Bankruptcy Act, 11 U.S.C. § 107d (1976), reads in pertinent part:

> "(2) Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this act by or against him is fraudulent . . . (d) as

> to then existing and future creditors, if made or incurred with actual intent as distinguished from intent presumed in law, to hinder, delay or defraud either existing or future creditors."

Section 68 of the Bankruptcy Act, 11 U.S.C. § 108 (1976), reads in pertinent part:

> "a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> "b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of Section 57 of this Act . . . ."

Section 57g of the Bankruptcy Act, 11 U.S.C. § 93g (1976), reads as follows:

> "The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this Act, shall not be allowed unless such creditors shall surrender such preference, liens, conveyances, transfers, assignments, or encumbrances."

STATEMENT OF THE CASE

Petitioner, A. Spencer Gilbert III, Trustee in Bankruptcy, ("Trustee") seeks to recover from Respondent, First National Bank of Jackson, Mississippi ("FNB") the sum of $496,241.40 which was setoff by the bank after it discovered a check-kiting scheme. The bank placed a freeze on the debtor's (now bankrupt's) accounts, and built up the accounts with the intent to setoff the balances against existing loans. The facts are without dispute and are essentially as found by the District Court and by the Court of Appeals.

(1) Statement of Facts

On April 2, 1974, FNB discovered a large check-kiting scheme in progress between the accounts of Charles E. Duran and his related companies (hereinafter collectively referred to as "Duran" or "bankrupt") at FNB and the accounts of Duran at Citizens National Bank of Jackson, Mississippi ("CNB"), located across the street from FNB.

Upon discovering the kite, FNB immediately put a freeze on all Duran accounts to prevent payment of any further checks, but continued to accept deposits to the accounts. FNB's stated intent in building up the accounts was to avoid any actual overdraft from the kite and to build up the maximum balance to setoff against Duran's loans.[1]

On April 5 FNB stopped receiving deposits to Duran's accounts. The balance in Duran's accounts had built up to an amount sufficient to cover the original potential overdraft of $443,686.45 and sufficient to setoff $496,241.40 against Duran's loans, paying FNB in full.

FNB did not notify Duran or CNB of its discovery of the kite or its freeze on the accounts.

On April 10 and 11, 1974, in three separate debit transactions, FNB effected the setoff and returned to Duran the collateral it held to secure the loans.

On August 22, 1974, (4 months and 11 days after the setoff), creditors filed an involuntary bankruptcy petition

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[1] Charles Bailey, Vice-President of FNB, testified as follows: "Of course our concern was that it was obvious to us that Mr. Duran had financial problems and our interest was to protect the bank from two particular standpoints, one being that we did not want to get hung on any of these checks that were floating between the two banks, and also *we wanted to offset as much as we possibly could against any existing debt that Mr. Duran had with us.*" (Transcript, p. 266) (Emphasis added).

against Char-Mac Enterprises, Inc. The next day the same creditors filed involuntary petitions against Mr. and Mrs. Duran. Each was subsequently adjudicated bankrupt.

(2) District Court Proceedings

The Trustee filed his complaint against FNB in October, 1976, in the United States District Court for the Southern District of Mississippi, to recover the funds setoff by the bank. The complaint averred that the setoff was made in bad faith and was, therefore, wrongful under Section 68, and that it was a fraudulent transfer under Sections 67d(2)(d) and 70e because the actions of FNB indicated "actual intent to hinder, delay or defraud" creditors of Duran.

After a two-day trial to the court without a jury, Judge Cox issued his ruling and opinion in favor of FNB and against the Trustee, finding that the Trustee failed to prove the "actual intent" required by Section 67d(2)(d). 463 F.Supp. 169, 172; App. B at 14a.

(3) The Court of Appeals Decision

The Court of Appeals for the Fifth Circuit affirmed the judgment against the Trustee, but based its decision on entirely different grounds. The Court found essentially the same objective facts as found by the District Court but did not address the issue of "bad faith" or "actual intent to hinder, delay or defraud." Rather, it based its ruling on two conclusions of law; namely, (a) the making of a setoff in bad faith and outside the ordinary course of business is not relevant when a setoff is attacked as a fraudulent transfer under Section 67d, as opposed to when it is attacked as a preference under Section 60, 633 F.2d at 688, App. A at 4a; and (b) a setoff is not a "transfer . . . by the debtor" for purposes of Section 67d(2)(d). 633 F.2d at 689, App. A at 5a.

REASONS FOR GRANTING THE WRIT

I. THE FIFTH CIRCUIT HAS DECIDED AN IMPORTANT ISSUE OF FEDERAL BANKRUPTCY LAW CONTRARY TO THE DECISIONS OF THIS COURT

This Court has recognized for at least 77 years that a bank has a right to setoff a depositor's funds against indebtedness to the bank *only* where the deposits were made in good faith in the ordinary course of business, and held by the bank subject to withdrawal by the depositor. *New York County National Bank v. Massey*, 192 U.S. 138 (1904). This right of setoff is recognized and is permitted to be enforced in bankruptcy by Section 68 of the Bankruptcy Act.[2] *Studley v. Bolyston National Bank of Boston*, 229 U.S. 523 (1913). This rule on bank setoffs has been followed in subsequent decisions of this Court. *Studley, supra;* and *Mechanics' & Metals National Bank v. Ernst*, 231 U.S. 60 (1913) (the bank heard that there was trouble with J. M. Fiske & Company and ordered a freeze on its accounts, after which the company deposited $54,048.08. A bankruptcy petition was filed against the company the same day. Speaking through Mr. Justice Holmes, the Court held that the deposit was a payment and a preference and the setoff was denied.)

Until the instant case, the circuit courts of appeal had uniformly followed the rule that a bank could setoff its depositors' checking accounts only where the deposits were received in good faith, in the ordinary course of business, and held subject to withdrawal. *Citizens' National Bank v. Lineberger*, 45 F.2d 522 (4th Cir. 1930); *Elliotte v. American Savings Bank & Trust Co.*, 18 F.2d

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[2] The new Bankruptcy Code, 11 U.S.C. § 553 (1978), "preserves, with some changes, the right of setoff in bankruptcy cases now found in Section 68 of the Bankruptcy Act." H.Rept. No. 95-595 to accompany H.R. 8200, 95th Cong., 1st Sess. (1977) p. 377.

460 (6th Cir. 1927); *Bank of Commerce & Trusts v. Hatcher*, 50 F.2d 719 (4th Cir. 1931); *Katz v. The First National Bank of Glen Head*, 568 F.2d 964 (2nd Cir. 1977), *cert. denied* 434 U.S. 1069; *In the Matter of Multiponics, Inc. (Multiponics II)*, 622 F.2d 725 (5th Cir. 1980); and *In the Matter of PRS Products, Inc.*, 574 F.2d 414 (8th Cir. 1978). See 4 Collier on Bankruptcy, ¶ 68.15 et seq. (14th Ed.)

In *Hatcher, supra*, the Fourth Circuit stated that "the principle upon which the right of set-off is denied . . . is that the bank, by refusing to permit checks to be paid from the account, has evinced an unequivocal intention that the deposit balance shall not be subject to withdrawal by the depositor, but shall be applied on the indebtedness due the bank, and consequently deposits thereafter made have the effect of payments and not of creating an ordinary deposit balance." 50 F.2d at 721.

In *Elliotte, supra*, the Sixth Circuit held that "the bank's right of set-off did not apply to deposits not received in the regular course of business, but received merely for the purpose of application on a pre-existing debt. *Union Trust Co. v. Peck* (C.C.A. 4) 16 F.(2d) 986, 987; *Essex Bank v. Hurley* (C.C.A. 1) 16 F.(2d) 427, 428. Cf. *Merrimack Bank v. Bailey, infra*, 289 F. 468. Nor to deposits received within the four months' period, when the depositor was insolvent, and when the bank had reasonable cause to believe that such deposits would effect a preference. *Merrimack Bank v. Bailey*, (C.C.A. 1) 289 F. 468, [*cert. denied* 263 U.S. 704]." 18 F.2d at 462.

The Fifth Circuit has previously stated and followed the general rule, in conflict with its decision in this case. In *Multiponics II, supra*, the Fifth Circuit stated: "Most importantly, technical legal arguments aside, the setoff on its face was suspect. Deposits procured for the purpose of effecting a setoff destroy the right of setoff and

are considered voidable preferential transfers. . . . We concur in the District Court's conclusion that the arrangement between Lehman and Citibank was characterized by less than good faith.

"We refuse to permit the possibility of a set up for a set-off." 622 F.2d at 725.

The undisputed and judicially determined facts in this case are that FNB discovered a fraudulent check-kiting scheme involving Duran's accounts at FNB and at CNB. FNB put a freeze on Duran's accounts without notice and for four banking days it built up deposits in the accounts of almost $500,000. FNB then setoff the entire amount in these accounts and thereby received full payment of Duran's loans.

II. A BANK SETOFF IS A "TRANSFER BY THE DEBTOR"

In holding that a setoff is not a "transfer by the debtor" for purposes of Section 67d, the Fifth Circuit has construed the Bankruptcy Act to permit the Trustee to attack wrongful setoffs only as preferential transfers and subject to the four month limitation. Section 60, Bankruptcy Act, 11 U.S.C. § 96 (1976).

The Court of Appeals noted that all wrongful setoff cases have been "concerned with preferences made within four months of bankruptcy" 633 F.2d at 688, App. A at 4a. This fact is not a valid reason for permitting a wrongful setoff within a year of bankruptcy where the setoff meets all of the other requirements of Section 67d(2)(d). A transfer may be either a preference or a fraudulent conveyance or both. *Dean v. Davis*, 242 U.S. 438 (1917).

So far as Petitioner can determine, this is the first reported case that has attacked a setoff as a fraudulent transfer under 67d. In analyzing this issue of first

impression, the Fifth Circuit drew the line sharply and with extreme literalism when it held that a setoff is not a "transfer . . . by the debtor" and, therefore, not subject to attack under Section 67d. Instead of giving the Bankruptcy Act the liberal construction intended by Congress and applied by this Court in the interests of equitable distribution in bankruptcy, the Fifth Circuit has limited the definition of "transfer" so that a bank setoff is a "transfer" for purposes of Section 60, but is not a "transfer" for purposes of Section 67d.

The definition of "transfer" in Section 1(30) of the Bankruptcy Act is stated in broad and sweeping language. The definition applies to Section 60 and Section 67d. 1 COLLIER ON BANKRUPTCY, ¶ 1.30 (14th Ed.). "The word 'transfer' has always had a most comprehensive meaning under the Bankruptcy Act and, even under the former more restrictive clause, has been construed to include every method of disposing of or parting with property or its possession." 1 COLLIER ON BANKRUPTCY, ¶ 1.30 (14th Ed.), citing *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 483, (1901).

To hold by narrow, literal construction that the setoff is not a "transfer . . . by the debtor" is to frustrate the obvious purpose of Section 67d which was added to the Bankruptcy Act in 1938 to give the trustee the right on behalf of general creditors to recover unfair and fraudulent transfers of property. As this Court has said in the context of interpreting the word "transfer" contained in Section 70d(5): "We do not read the statutory words with the ease of a computer. . .; [t]here is an overriding consideration that equitable principles cover the exercise of bankruptcy jurisdiction." *Bank of Marin v. England*, 385 U.S. 99 at 103 (1966).

CONCLUSION

For the foregoing reasons, Petitioner respectfully prays that a Writ of Certiorari issue to review the Judgment and Opinion of the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES OF APPEALS
FIFTH CIRCUIT
UNIT A

No. 79-1310

A. SPENCER GILBERT, III, Trustee in Bankruptcy for Char-Mac Enterprises *et al*,
Plaintiffs-Appellants,

v.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Defendant-Appellee.

Dec. 29, 1980

Appeal from the United States District Court for the Southern District of Mississippi

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Before WISDOM, GARZA and REAVLEY, Circuit Judges.

REAVLEY, Circuit Judge:

The trustee in bankruptcy for the bankrupts, Charles C. Duran, his wife, and his wholly owned corporation, Char-Mac Enterprises, Inc., bring this suit in an attempt to avoid a setoff by First National Bank of Jackson, Mississippi (FNB) against secured debts owed the bank by the bankrupts. He contends that the setoff was im-

proper under § 68 of the Bankruptcy Act and a fraudulent conveyance under § 67(d)(2)(d) of the Bankruptcy Act. 11 U.S.C. §§ 107(d)(2)(d), 108 (1976) (repealed 1978).[1] The district court determined that the trustee had failed to prove the requisite fraudulent intent on the part of FNB and, therefore, refused to set aside the setoff. The trustee appeals, insisting that the district court erred in its determination of FNB's good faith. We affirm the judgment of the district court.

I.

Charles Duran had three checking accounts at FNB—as well as outstanding secured loans amounting to approximately $500,000. He also had various accounts and loans at Citizens National Bank (CNB), another bank in Jackson. Duran was engaged in kiting checks between his accounts with the two banks. He would deposit a check drawn on a CNB account into an FNB account and immediately write checks on the deposited amount. FNB would pay the latter checks, although they were being paid against uncollected funds. FNB would not be certain that the deposited checks on the CNB account had been finally paid by CNB until after the check clearing process had been completed on midnight of the day following the day FNB presented the check to CNB for payment. This is the "midnight deadline rule" set forth in the Uniform Commercial Code, § 4-302, Miss.Code Ann. § 75-4-302. Duran was engaged in the same process—making large deposits and writing checks on the balance before it was collected—at CNB. A kite collapses

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[1] This case is governed by the old Bankruptcy Act (repealed November 6, 1978 by Pub.L.No. 95-598, 92 Stat. 2549) because it commenced under that Act. *Id.* § 403(a), 92 Stat. 2683. In the text of this opinion, all references to sections of that Act will be to the section number of the Act itself rather than to the superceded Union States Code sections.

only when one bank discovers it or for any reason refuses to pay checks drawn against uncollected funds. When that bank returns a check that was deposited in the other bank, the other bank is left with a loss if it has paid checks against those uncollected funds. Therefore, the first bank to discover the kite is usually in the best position to relieve itself of any loss.

On Tuesday, April 2, 1974, FNB discovered that it had been paying large amounts of money against uncollected funds in Duran's accounts. The bank officers immediately suspected a kite and "froze" all of Duran's FNB accounts so that no more checks would be paid. Deposits, however, were still accepted into those accounts. FNB had paid $443,686.45 against uncollected funds drawn on the Duran accounts the previous Thursday and Friday, March 28 and 29. They had also accepted some of Duran's checks for payment on Monday. FNB reversed and returned the Monday checks as drawn against uncollected funds, as it was entitled to do since the midnight deadline had not yet passed. The bank was left with a possible loss, however, on the checks paid the week before.

FNB did not at that time notify CNB or Duran of the discovered kite. The officers of FNB merely waited to see if CNB would pay the checks deposited in the FNB accounts as was necessary for FNB to recover the $443,686.45 paid earlier. Apparently, by Friday, April 5, FNB became certain that it would not have to bear losses because of Duran's kite. CNB discovered the kite on Thursday, April 4, and began returning checks which Duran had deposited in his FNB account. When the air cleared and the accounts settled, FNB had collected enough funds to cover the checks paid March 28 and 29 and approximately $500,000 in excess of that amount. CNB was faced with a loss. On Monday, April 7, FNB decided to accelerate Duran's notes and set the amount

due off against the collected balances in the accounts. FNB carried out the setoff on April 9 when it returned the notes and the collateral to Duran.

II.

The trustee first attacks the setoff itself, contending that it is void under § 68 of the Bankruptcy Act. Section 68 provides for the setoff of mutual debts between a bankrupt and a creditor.[2] Under the Act, such setoffs are allowed in the distribution of the bankrupt's estate and within the four month preference period covered by § 60 of the Act, as well as in the period covered by § 67(d). The trustee here claims FNB's setoff is voidable because it was made outside of the ordinary course of business and in bad faith. In support of his position the trustee brings to our attention several cases in which courts have refused to allow a setoff for these reasons. *In re Multiponics, Inc.*, 622 F.2d 725 (5th Cir. 1980); *Katz v. First National Bank of Glen Head*, 568 F.2d 964 (2d Cir. 1977); *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir. 1959). These cases, however, are concerned with preferences made within four months of bankruptcy, covered by § 60 of the Bankruptcy Act. Our case is not such a preference case. Since the setoff occurred more than four months before the bankruptcy, this case is controlled by § 67(d).[3]

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[2] Section 68(a) provides:

> In all cases of mutual debts or mutual credits between the estate of the bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

[3] It is true that a setoff may be void if a true debtor-creditor relationship does not exist between the bank and its depositor, because the requisite mutuality of obligation is no longer present. *See Multiponics*, 622 F.2d at 728, *In re Applied Logic Corp.* 576 F.2d 952, 958 (2d Cir. 1978). When a customer deposits funds

III.

A set off of mutual debts made in the time frame covered by § 67(d) may be set aside only if the trustee satisfies the requirements of the statute. The trustee here proceeds under § 67(d)(2)(d), which provides:

> "Every transfer made or every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent . . . (d) as to then existing or future creditors, if made or incurred with actual intent . . . to hinder, delay or defraud either existing or future creditors."

In order to satisfy the statute the trustee must first present us with a "transfer . . . by the debtor". The only "transfer" by Duran here is the deposits made into his FNB accounts that FNB collected and used to setoff the pre-existing debts. The setoff itself is not a transfer by Duran because he had no control over it; FNB had the right to execute the setoff, and did so. It is well settled that deposits in an unrestricted checking account made in the regular course of business do not constitute transfers within the meaning of the Bankruptcy Act since they create a debtor-creditor relationship between the bank and the depositor. *New York County National Bank v. Massey*, 192 U.S. 138, 145, 24 S.Ct. 199, 200, 48 L.Ed. 380 (1904); *Katz*, 568 F.2d at 969; *Mayo*, 270 F.2d at 837 n.21. The Bankruptcy Act contemplates transfers that deplete the estate of the bankrupt or prefer one creditor at the expense of another. Such is not the case when the bankrupt makes a deposit into his general

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into an ordinary checking account, the bank becomes indebted to the customer, and a debtor-creditor relationship exists between the bank and the depositor. *Multiponics*, 622 F.2d at 728. This is also the rule in Mississippi. *Citizens National Bank v. First National Bank*, 347 So.2d 964, 968 (Miss.1977).

checking account. When Duran deposited CNB checks into his FNB accounts he was merely obtaining an obligation owed by FNB by the cancellation of an obligation owed by CNB. It had no effect on his estate or his creditors. Duran's deposits into his FNB accounts, therefore, cannot be considered "transfers" under § 67(d)(2).

The judgment of the district court is, therefore, AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
S. D. MISSISSIPPI
JACKSON DIVISION

Civ. A. No. J76-305(C)

A. SPENCER GILBERT, III, Trustee in Bankruptcy for Char-Mac Enterprises, Inc., Trustee in Bankruptcy for Charles E. Duran, and Trustee in Bankruptcy for Rachel R. Duran,

Plaintiff,

v.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,

Defendant.

Jan. 5, 1978

WILLIAM HAROLD COX, District Judge.

This controversy involves the propriety and legality of the action of the First National Bank in applying certain fund as a set off against a secured debt of the bankrupts to the bank. Charles E. Duran was the owner of several different corporations, including Char-Mac Enterprises, Inc., and was engaged in a practice of kiting checks between Citizens National Bank (CNB) and First National Bank (FNB), both in Jackson, Mississippi. The plaintiff contends that the course adopted by First National Bank in satisfying its indebtedness was done with the actual intent to hinder, delay or defraud the creditors of the bankrupts in violation of 11 U.S.C. § 107d(2)(d).[1]

[1] 11 U.S.C.A. § 107d(2)(d) provides: "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this title by or

The defendant denies any intent to hinder, delay, or defraud creditors but insists that its actions at all times were in keeping with its legal rights. Charles E. Duran, acting for his several corporations and engaged in a vast dollar amount of transactions, in the case at bar would draw checks on CNB and deposit them in FNB for collection without any kind of authority or approval from CNB and in such manner build a fictitious balance on deposit in the bankrupts' account at FNB until such fraud was discontinued and stopped. On April 2, 1974, FNB became suspicious of Duran's kiting activities. Thus for approximately two days, or through April 4, 1974, it continued to accept deposits through CNB while discontinuing paying out any withdrawals from FNB. On April 4, 1974, FNB discontinued accepting any deposits drawn by the bankrupts through CNB. On April 9, 1974, FNB utilized a provision in its secured notes of the bankrupts to accelerate and mature its indebtedness and to use the accumulated balance of bankrupts' accounts with the bankrupts to pay their indebtedness in the amount of $496,241.40.[2]

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against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent; or (b) as to then existing creditors and as to other persons who become creditors during the continuance of a business or transaction, if made or incurred without fair consideration by a debtor who is engaged or is about to engage in such business or transaction, for which the property remaining in his hands is an unreasonably small capital, without regard to his actual intent; or (c) as to then existing and future creditors, if made or incurred without fair considertion by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature; or (d) as to then existing and future creditors, if made or incurred with actual intent as distinguished from intent presumed in law, to hinder, delay, or defraud either existing or future creditors."

[2] On the face of each collateral note signed by the bankrupts to FNB is the following provision: ". . . Upon the happening of any

First National Bank exercised its option under the conditions of said notes to accelerate and declare due and payable all of the obligations of said bankrupts. Under the circumstances and conditions existing between FNB and with such notes as FNB had which CNB sought to have considered as knowledge of such check kiting practices of the bankrupts, CNB sued FNB for stopping payment on those checks drawn on FNB after FNB stopped payment thereon while continuing to receive deposits into said account for approximately two days. Citizens National Bank contended that FNB owed it the courtesy, if not the duty, to advise it as to what Duran was suspected of doing in connection with such kiting option. The Chancery Court of Hinds County sustained a demurrer to said bill of complaint shown in this record, and the Supreme Court of Mississippi affirmed said decision which in effect held that these two banks were acting in competition with each other and dealt at arm's length with each other, and that FNB had no duty or obligation of any kind to treat CNB as a fiduciary.[3]

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of the following events, each of which will constitute a default hereunder, all liabilities of Maker to Bank shall become immediately due and payable at the option of Bank; . . . (5) determination by any officer of Bank that a material adverse change has occurred in the financial condition of Maker or any party hereto. Upon occurrence of any such event or at any time thereafter, Bank shall have the remedies of a secured party under the Uniform Commercial Code of Mississippi . . .

"Bank shall have a security interest in the moneys or property at any time in possession of Bank belonging to Maker or any other party liable hereon and any deposit due by Bank to Maker or any other such party, all of which shall be treated as security for payment of this note. Bank may, at its option in event of default, set off such moneys, property or deposits against this note or any other obligation of Maker . . ."

[3] *Citizens National Bank v. First National Bank*, 347 So.2d 964 (Miss.) where the court reaffirmed its long standing decision to the effect that the relationship between the bank and the depositor

That position of these two banks has not been altered or changed in any respect by anything subsequently done. Thus, this Court is confronted with a situation where the question before the Court involving the rights of the Trustee in Bankruptcy of these bankrupts to have set off the deposits in FNB against the established obligations of these bankrupts is presented. The question of set off was not involved in the proceeding but could have been involved between the parties and their privies to that state litigation.[4]

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is that of debtor and creditor, and that a check is merely an order and not an assignment of funds on deposit; that the bank may refuse to pay a check although the depositor has sufficient funds to his credit to cover the check, and the holder of the check has no cause of action against the bank. The holder of the check must look to the drawer of the check and only the drawer can complain about the bank not honoring his check. The bill of complaint could not withstand the impact of a demurrer. Significantly, on presentation and consideration of the sweep of the doctrine of res judicata, the plaintiff here is confronted with the established fact of the scope and range of res judicata under the circumstances and conditions of the instant case.

[4] *National Life & Accident Insurance Co. v. Prather*, 172 Miss. 567, 161 So. 117, 118 holds: "The rule with reference to res adjudicata is that, not only are matters included which are actually pleaded, but all matters which could have been set up in a former suit. See Mississippi Digest Annotated, Judgments, § 713; *Dean v. Board of Supervisors*, 135 Miss. 268, 99 So. 563; *Bates v. Strickland*, 139 Miss. 636, 103 So. 432, and other cases cited in the Mississippi Digest."

Browne v. Merchants Co., 186 Miss. 430, 191 So. 120, 122 the Court held: "We think the judgment of the court below was correct because the rule is that all matters embraced in the former judgment and all matters that could have properly been pleaded in said cause are concluded by the judgment rendered. Mississippi Digest Annotated, Volume 9, Judgment, 713, collates the authorities upon the proposition. It is therein stated that a judgment or decree on the merits rendered in a former suit between the same parties and their privies upon the same cause of action, by a court of competent jurisdiction, is conclusive, not only as to all matters determined, but also is conclusive as to matter which might or

ought to have been litigated. The former suit was for the same collision and between the same parties for the same negligence of the alleged driver, and suit was brought some two years after the alleged injury occurred, and the matters attempted to be set up to distinguish facts in the present case from the former case could then have been plead, and certainly should have been known by diligent inquiry as to the facts."

Pray v. Hewitt et ux., 254 Miss. 20, 179 So.2d 842, 844 the Court held: "The Latin idiom 'res judicata' means the thing has been decided. In law, it means the same issue has been decided by a court of competent jurisdiction. Since the time of ancient Roman law, there have been four conditions essential to establish the plea of res judicata. They are (1) identity in the things sued for, (2) identity of the cause of action, (3) identity of persons and parties to the action, and (4) identity of the quality or character in the person against whom the claim is made. 50 C.J.S. Judgments § 598, Essential elements, p. 18 (1947). All of the foregoing elements of res judicata appear in the pleading in the case at bar.

"There is another reason why the plea of res judicata should have been sustained as a bar to the instant suit: The original contract between the parties with reference to the land was attached to the answer in the former suit. In that suit the answer alleged that the Hewitts fully complied with the attached contract, and denied fraud or false representations in obtaining the deeds. The contract was pertinent to the issue involved and was plead and tendered as an issue in the former suit. Therefore all rights to enforce the contract were settled by the former decree.

"It is pointed out in 50 C.J.S. Judgments § 716, p. 186 (1947) that 'The rule is often broadly stated in general terms that a judgment is conclusive not only on the questions actually contested and determined, but on all matters which might have been litigated and decided in that suit.' This rule has been approved and adopted in this State. See *Johnson v. Bagby*, 252 Miss. 125, 171 So.2d 327 (1965); *Taylor v. Bell*, 194 Miss. 112, 11 So.2d 825 (1943); *Townsend v. Beabers*, 185 Miss. 312, 188 So. 1, 189 So. 90 (1939); *National Life & Acc. Ins. Co. v. Prather*, 172 Miss. 567, 161 So. 117 (1935); *Lion Oil Ref. Co. v. Crystal Oil Co.*, 171 Miss 36, 156 So. 593 (1934); *Darrow v. Moore*, 163 Miss. 705, 142 So. 447 (1932); *Love v. Mayor & Bd. of Aldermen of Yazoo City*, 162 Miss. 65, 138 So. 600 (1932); *Gaines v. Kennedy*, 53 Miss. 103 (1876)."

Forbes *et ux. v. Columbia Pulp and Paper Co., Inc.*, Miss., 340 So.2d 734, 736 the Court held: "Res Judicata is not only a bar to

This case involves the same funds which were involved in that state case, and these bankrupts and their trustee are certainly privies thereto. The question of set off between the parties to the instant case was not before the Court in the bill of complaint and judgment of the trial court on the demurrer and in the Supreme Court of Mississippi on its affirmance of that final decree in the Chancery Court of Hinds County, Mississippi.

The principle of set off in a case of this kind has been before the Court on many occasions and equity has always recognized and applied the doctrine in wholesome instances. There is simply nothing to be found as an ultimate fact which will support any contention of fraud or unfairness just because FNB suspected Duran of kiting checks and thus ballooning his deposits with FNB even though it continued to allow Duran to make deposits into said account, stopped all cashing of checks on said account. First National Bank simply had no fiduciary relationship with CNB and was not obliged to reveal to it what it knew and what it suspected since CNB was a competitor in active competition with it at all times during every phase of its activities involving these checks of Duran drawn on CNB and deposited in his accounts with FNB. The plaintiff charged and must prove by the

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further litigation concerning the exact issues of the former lawsuit, but goes further as set out by this court in the case of *Pray v. Hewitt*, 254 Miss. 20, 179 So.2d 842 (1965), wherein the Court said: '. . . [T]he rule is often broadly stated in general terms that a judgment is conclusive not only on the questions actually contested and determined, but on all matters which might have been litigated and decided in that suit.' This rule has been approved and adopted in this State. 254 Miss. at 24, 179 So.2d at 844. Likewise, the Court stated in the case of *Golden v. Golden*, 246 Miss. 562, 151 So.2d 598 (1963): Moreover, a prior suit conclusive in a subsequent suit not only of matters actually determined, but also matters which could and should have been determined in the prior suit. 246 Miss. at 568, 151 So.2d at 600."

greater weight of the more convincing evidence that defendant acted as it did with intent to hinder, delay, or defraud the creditors of the bankrupts. That it has not done in this case.[5]

The Trustee in Bankruptcy as plaintiff has presented to this Court a question of fact for its resolution. The Trustee contends and must prove to prevail that the defendant under these circumstances before the Court

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[5] *United States v. Bank of Shelby* (5 CA) 68 F.2d 538, 539 the Court held: "The general rule in the absence of statute is that to set off an unmatured debt because of insolvency requires the action of equity; *Scott v. Armstrong*, 146 U.S. 499, 13 S.Ct. 148, 36 L.Ed. 1059; *Hecht v. Snook*, 114 Ca. 921, 41 S.E. 74; but that insolvency alone is a sufficient basis in equity for the set-off not only as between the parties but as against a receiver, an assignee for the benefit of creditors, a trustee in bankruptcy, or a garnisher. *Scott v. Armstrong, supra; Nashville Trust Co. v. Fourth National Bank*, 91 Tenn. 336, 18 S.W. 822, 15 L.R.A. 710; *Hayden v. Citizens' National Bank*, 120 Md. 163, 87 A. 672, 46 L.R.A. (N.S.) 1059, Ann.Cas. 1915A, 686; *Wunderlich v. Merchants' Nat. Bank (Armitage Herschel Co. v. Jacob Barnett Co.)*, 109 Minn. 468, 124 N.W. 223, 27 L.R.A. (N.S.) 811, 134 Am.St.Rep. 788, 18 Ann.Cas. 212. But there is present here another potent fact, that the two obligations arose out of the same transaction and the one is the consideration for the other. It would be manifestly inequitable to enforce one obligation when the other cannot be enforced. This element was given effect in a case from Pennsylvania, where there was no chancery jurisdiction as such, in *Dushane v. Benedict*, 120 U.S. at page 639 et seq., 7 S.Ct. 696, 30 L.Ed. 810. In *Scott v. Armstrong, supra*, the circumstances were like those of the case at bar except that it was the bank which became insolvent. It was said at page 507 of 146 U.S., 13 S.Ct. 148, 150: 'Courts of equity frequently deviate from the strict rule of mutuality when the justice of the particular case requires it, and the ordinary rule is that, where the mutual obligations have grown out of the same transaction, insolvency on the one hand justifies the set-off of the debt due upon the other.' "

The principles and application of set off are illustrated and demonstrated in *Aetna Casualty and Surety Company v. Atlantic National Bank of West Palm Beach* (5 CA) 430 F.2d 574.

acted with actual intent as distinguished from intent presumed in law to hinder, delay, or defraud either existing or future creditors of these bankrupts. That it has not done.[6]

The plaintiff, as the duly appointed, qualified and acting Trustee of these three bankrupts, has instituted a five count complaint in this Court on October 15, 1976 and seeks to recover from FNB a large sum of money. This Court has heard and considered this case extensively, together with excellent briefs of counsel, and is of the opinion and so holds that the plaintiff has not established his claim by the greater weight of the more convincing evidence, but the evidence and testimony in this case has demonstrated to this Court that the complaint in its entirety is without merit and should be dismissed. The complaint of the plaintiff in this case is without merit and will be dismissed at his cost.

A judgment accordingly may be prepared and presented to the Court for entry within five days under the rules of this Court.

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[6] *In the Matter of Southern Land Title Corporation, Debtor, In Re Southern Land Title Corporation and the Five Flags Building, Inc.*

Appeal of Albert J. Ward, Jr., Trustee (5 CA) 474 F.2d 1033.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 79-1310

D.C. Docket No. CA-J76-305(C)

A. SPENCER GILBERT III, Trustee in Bankruptcy for Char-Mac Enterprises, *et al.*,
Plaintiffs-Appellants,

versus

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of Mississippi

Before WISDON, GARZA and REAVLEY, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States Distrit Court for the Southern District of Mississippi, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of said District Court in this cause be, and the same is hereby affirmed;

IT IS FURTHER ORDERED that plaintiffs-appellants pay to defendant-appellee the costs on appeal, to be taxed by the Clerk of this Court.

December 29, 1980

ISSUED AS MANDATE: February 27, 1981.

APPENDIX D

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT
UNITS A & B

No. 79-1310

A. SPENCER GILBERT III, Trustee in
Bankruptcy for Char-Mac Enterprises, *et al.*,
Plaintiffs-Appellants

versus

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Defendant-Appellee.

Appeal from the United States District Court for the
Southern District of Mississippi

ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC

(Opinion December 29, 1980, 5 Cir., 198 —, — F.2d —).

Before WISDON, GARZA and REAVLEY, Circuit Judges.

PER CURIAM:

The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellant Procedure; Local Fifth Circuit Rule 16) the Petition for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ Thomas M. Reavley
United States Circuit Judge

[Filed: February 17, 1981]

Office-Supreme Court, U.S.
FILED
JUL 17 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-1935

In the Supreme Court of the United States

October Term, 1980

A. SPENCER GILBERT III, Trustee in Bankruptcy
for Char-Mac Enterprises, Inc., et al.,
Petitioner,

vs.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Respondent.

BRIEF OF FIRST NATIONAL BANK OF JACKSON, RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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PARTIES

The Respondent is First National Bank of Jackson.

The parent corporation for the Respondent is First Capital Corporation, a Mississippi corporation.

F.S. Corporation, a Mississippi corporation, is a wholly owned subsidiary of First Capital Corporation, and therefore under Rule 28.1 may be considered an affiliated corporation of the Respondent.

TABLE OF CONTENTS

PARTIES I
TABLE OF AUTHORITIES III
SUPPLEMENTAL STATEMENT OF THE CASE 1
ARGUMENT 3
CONCLUSION 7

TABLE OF AUTHORITIES

CASES

Citizens National Bank v. Linberger, 45 F.2d 522, 526 (4th Cir. 1930) 6
In re Applied Logic Corp., 576 F.2d 952, 962 (2nd Cir. 1978) 4, 5
New York County National Bank v. Massey, 192 U.S. 138, 145-47 (1904) 6

STATUTES

Bankruptcy Act:
Section 60, 11 U.S.C. § 96 (1976) 3, 4, 5, 6
Section 67d, 11 U.S.C. § 107d (1976) 1, 3, 4, 5, 6, 7
Miss. Code Ann. § 75-4-302 (1972) 2

No. 80-1935

In the Supreme Court of the United States

October Term, 1980

A. SPENCER GILBERT III, Trustee in Bankruptcy
for Char-Mac Enterprises, Inc., et al.,
Petitioner,

vs.

FIRST NATIONAL BANK OF JACKSON, MISSISSIPPI,
Respondent.

BRIEF OF FIRST NATIONAL BANK OF JACKSON, RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

SUPPLEMENTAL STATEMENT OF THE CASE

The Trustee distorts the facts. The District Court found First National Bank of Jackson (FNB) acted in good faith in putting a stop to Duran's kite and in effecting the setoff. The trial court specifically found FNB acted without "actual intent" to defraud as required under § 67d. 463 F. Supp. at 172. The Court of Appeals affirmed.

According to the Trustee, FNB's only purpose in refusing to pay checks drawn on Duran's account was to "build up" the balance in the account so as to later set it

off against Duran's unrelated indebtedness to the bank. Yet the District Court found directly to the contrary and the Court of Appeals affirmed. According to the courts beneath, FNB's purpose in freezing Duran's account was an entirely honorable one, to fight Duran's kite. When FNB initially froze Duran's account, its motivation was to save the bank from a loss on the kite, not to collect an unrelated debt from Duran. Because of the "midnight deadline" rule (Miss. Code Ann. § 75-4-302 (1972)), FNB was seriously exposed. If Citizens National Bank (CNB) had discovered the kite before FNB, it could have returned Duran's checks drawn on his CNB account to FNB. In such event, it would have been FNB, not CNB, which would have been left with a large loss on the kite.

Finally, the Trustee mentions FNB's return of collateral to Duran after the setoff, but fails to tell the Court the value of that collateral or what was done with it after FNB released it. At trial, witnesses for FNB testified the collateral had a value of at least $500,000. The Trustee produced no evidence to the contrary. After FNB liquidated Duran's $500,000 indebtedness by means of the setoff, this $500,000 in collateral was immediately pledged against Duran's loans with CNB. Since FNB released collateral worth at least as much as the indebtedness it liquidated, it is small wonder the Fifth Circuit could find no "transfer" or "depletion of the bankrupt's estate" as a result of the setoff attacked by the Trustee.

ARGUMENT

The Trustee asserts the Petition for Certiorari should be granted (1) because the decision beneath is "contrary to the decisions of this Court" and (2) because the case presents an "issue of first impression." Passing over the obvious contradiction inherent in so framing the issues,* the Trustee is wrong on both counts. The decisions of this Court are neither contrary to the decision beneath of the Court of Appeals for the Fifth Circuit nor do they support the Trustee's position, which has, in fact, been rejected by at least one appellate court.

The Trustee says § 67d condemns as fraudulent, as a matter of law, any setoff made within one year of the filing of the bankruptcy petition if, prior to the setoff, the bank permitted the balance in the depositor's account to rise or "build up." In the first place, such a contention is in the face of the language of § 67d itself which requires a finding, not of legal or presumed fraud, but of fraud in fact. The second difficulty with the Trustee's theory is that there is absolutely no case law to support it. The Trustee's proposed requirement that the deposits into the bank account be made in "the regular course of business" is a requirement under § 60 of the Act (transfers within four months of filing), but there is not one decision imposing such a requirement in the context of § 67d. As noted in the opinion beneath of the Court of Appeals, every case cited in the Trustee's petition is a § 60 case. In each decision in which the "regular course of business" requirement was imposed, the setoff occurred within four months of the filing. In the instant case, the setoff occurred more than

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*How can a case be one for which there is no controlling precedent and also one which has been decided contrary to existing precedent?

four months prior to filing and is, therefore, outside the ambit of § 60. The "regular course of business" test has no application.

The existing law, the law which the Trustee asks this Court to change, is that setoffs are permitted both within the one year period of § 67d and within the four month period of § 60, but a setoff made within four months of filing is a voidable preference under § 60 to the extent the deposits made to the accounts were not in the regular course of business. That is, if at the time the bank received the deposits, it had already made a conscious decision to apply them to an unrelated debt of the depositor, and if the setoff is then effected within four months of the filing of the petition, then the setoff is violative of the bankruptcy laws. *In re Applied Logic Corp.*, 576 F.2d 952, 962 (2nd Cir. 1978). Contrary to the Trustee's position, there is no requirement that deposits in a § 67d case be made in the regular course of business. This is true because transactions within one year of filing are too remote in point of time to be considered questionable and therefore not entitled to the presumption of fraud or overreaching applicable to a § 60 transfer.

The trustee in *Applied Logic, supra,* made a similar attack on a setoff, contending that the transaction in question should be set aside because the deposits were not made in the ordinary course of business. The Second Circuit rebuffed the trustee, holding the "regular course of business" requirement has no field of operation outside § 60.

> The trustee argues alternatively that [the bank] had no right of setoff because the deposits were not made in the regular course of business and were not withdrawable at the will of the depositor. This raises the question whether this often used language is a judicial gloss imposed on Section 68a regardless of the

time when the deposits were made or simply an affirmation that Section 68a cannot be used to validate what would otherwise be a preference voidable under §§ 60a and b.

The latter conclusion is dictated both by reason and authority as recent as this court's decision in *Katz v. First National Bank of Glen Head*, 568 F.2d 964 (2d Cir. 1977).... 576 F.2d at 961-62.

The *Applied Logic* opinion goes on to state that deposits failing to comply with the "regular course of business" requirement which were made within four months of bankruptcy could *not* be setoff; however, those deposits made, even though not in the regular course of business, more than four months from the date of bankruptcy were unobjectionable under the Bankruptcy Act. 576 F.2d at 962-63. The holding beneath brings the Fifth Circuit into agreement with the Second. The "regular course of business" rule applies *only* when the question is whether a preference may be avoided under § 60. The regular or ordinary course of business principle has no place in a § 67d case.

Even if this Court were disposed to embrace the Trustee's position on "regular course of business," this is not the proper case in which to do so because the result would remain the same. The trial court found the Trustee's contentions of bad faith without support in the record. Implicit in that finding is a rejection of Trustee's contention that FNB decided to "build up" the balance in Duran's account in order to set it off against his debt. Instead, the District Court accepted FNB's argument that its purpose in freezing Duran's account was to stop the kite. The affirmance by the Court of Appeals was based in part on this finding. Rather than create some new principle as the Trustee claims, all the Fifth Circuit did in its decision

beneath was to conclude that since the deposits *were* made in the regular course of business, the trial judge's conclusion that there had been no fraud in fact on the part of FNB was supported by the evidence. To establish a new principle requiring a regular course of business finding in a § 67d case, as well as in a § 60 case, would not affect the outcome in this case since there is already a finding (unchallenged here) that the deposits in question *were* made in the regular course of business.

The fallacy in the reasoning of the Trustee is apparent in his characterization of the Fifth Circuit's ruling as one to the effect that a setoff by a bank is not a "transfer" under § 67d. What the appellate court beneath actually said was that a deposit to a checking account by one who, more than four months thereafter, files for bankruptcy is not a transfer under § 67d. This is so because it does not deplete the bankrupt's estate. It is simply a change in the nature of an asset. *New York County National Bank v. Massey*, 192 U.S. 138, 145-47 (1904); *Citizens National Bank v. Linberger*, 45 F.2d 522, 526 (4th Cir. 1930) ("A deposit in a bank is not a sale or parting with property, or its possession, as a payment, pledge, mortgage, gift or security. It does not deplete the estate of the depositor. . . .")

Finally, the Trustee is asking the Court to devote its limited judicial resources to the creation of a legal principle which will have no precedential value in future cases. The case at bar was filed under, and is controlled by, the old Bankruptcy Act.

CONCLUSION

Even if one accepts all the contentions of the Trustee, FNB will prevail on the merits. All the bank did was (1) attempt to protect itself from Duran's massive and fraudulent check writing scheme and (2) attempt to protect itself from a loss on Duran's indebtedness. As both courts beneath have found, there was no fraud in fact on the part of the bank. A contrary finding is absolutely necessary if the Trustee is to prevail under § 67d. The Trustee cannot prevail where FNB merely employed legitimate means to protect its own proper interests.

Respectfully submitted,

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July 15, 1981